WHAT TO EXPECT WHEN YOU’RE EXPECTING TAX LAW CHANGES
In January 2019, the Democrats took control of the House of Representatives while the Republicans held on to the Senate. Shortly thereafter, the 2020 campaign season started. While early days, it’s already clear that personal taxes will figure heavily into the political debate. The federal budget deficit, which stands at $779 billion for FY 2018—and is projected to reach $897 billion for FY 2019—represents one catalyst.\(^1\) Rising economic inequality is another. The top 0.1% of US households hold nearly as much wealth as the bottom 90% of US households put together, according to the 2018 World Inequality Report.

In this paper, we review some possible tax changes and their impact on various groups of taxpayers, if adopted. We then explore steps clients could take to better position themselves before—and, in some cases, after—a new tax proposal becomes law.

**A CLOUDY OUTLOOK**

From the outset, we must caution that the outlook for the future direction of tax rates remains uncertain. Potential increases, particularly those that rise progressively with income, are often touted as an avenue to reduce the deficit and pay for new programs while simultaneously addressing inequality. However, in this election cycle, another highly unorthodox school of thought has begun to emerge, known as Modern Monetary Theory ("MMT").

MMT’s appeal relies on the assumption that a country that issues its own currency doesn’t need to worry about its deficits because:

1. it can always print money to pay interest; and
2. the government can spend unlimited amounts on infrastructure and other programs, provided enough workers and equipment exist to meet labor demand without stoking inflation.

In short, proponents of MMT don’t think taxes necessarily need to go up to fund additional spending or pay down debt. While we don’t envision this line of thinking gaining much traction, the fact that it has entered the conversation—and that both political parties seem comfortable with higher deficits—may reduce the pressure for increased taxes.

---

\(^1\) Source: Congressional Budget Office Monthly Budget Review, November 7, 2018, and Budget Projection as of January 28, 2019.
COMPETING VIEWPOINTS
That said, more traditional "solutions" for a high deficit and rising inequality continue to be discussed. On one side, the Republicans believe that tax cuts stimulate growth, which will increase receipts and reduce deficits. As a result, they want to make permanent certain temporary provisions of the Tax Cuts and Jobs Act (TCJA), which took effect January 1, 2018. Such provisions include reduced federal income tax rates, simplified deductions and an increased basic exclusion amount for gift and estate taxes.

In contrast, some Democrats argue that tax rates need to rise to support increased spending. They’re calling for higher taxes—especially on wealthy individuals—including a much higher top marginal tax rate, increased estate taxes, or a new wealth tax. One wager we would be willing to make? That future tax rates are unlikely to rest below where they are today.

PERMANENT CHANGES ARE A FALLACY
All of this tax talk may leave some thinking: didn’t we just overhaul the tax law? As it turns out, the tax code has changed—sometimes "permanently"—multiple times in the last three decades. For instance, the left side of Display 1 illustrates the evolution of the top ordinary income and capital gains tax rates, while the right side shows how the estate tax exclusion and rate have fluctuated over the same period.

Headline rates aside, the tax code is riddled with temporary provisions (known as tax extenders) that require Congress' annual or biennial renewal. In other words, there’s nothing permanent about our tax system and there hasn’t been for a long time.

PLANNING AMIDST UNCERTAINTY
The challenge becomes how to plan for your long-range goals when the income and estate tax landscape may shift around you. Should you, for example, save money in tax-deferred accounts today if the tax rate may be higher when those funds are withdrawn? Or should you take advantage of a large estate tax exclusion now to transfer wealth to your heirs even if that means losing out on a valuable future "step-up" in cost basis?

While it’s tempting to delay taking action, that could be a mistake. Several strategies are likely to prove far more beneficial if adopted today instead of years from now, even if tax law doesn’t change or fluctuations prove transient. The key is to adopt a plan that limits your tax exposure and can be canceled at little or no cost, if the need arises.

INCOME-TAX RATE CHANGES: WHAT CAN YOU DO?
Portfolio tax-management represents a multiyear challenge that accounts for the impact of income taxes not just in the current year, but in future years. For instance, if you knew capital gains tax rates were set to rise, you might take gains in the current year. While this means remitting taxes today (and forgoing profit potential on the amount paid), avoiding the higher rate may be worth the opportunity cost of deferring that tax to a later date. Conversely, harvesting losses before an increase would be suboptimal because loss harvesting represents a deferral strategy. While it lowers the overall cost basis of your portfolio, it doesn’t eliminate the embedded gain—it simply defers it into a higher tax rate environment.

Here are some other choices your professional advisors can help you evaluate if and when it becomes clear how a change in the law will affect your tax liability:

- Relocating to a state with lower or no income taxes.
- Paying down your mortgage versus keeping funds invested in the capital markets. Depending on your interest rate and ability to deduct interest, the mortgage may cost more than you are earning from your portfolio.
- Accelerating charitable gifts in tax years 2019 and 2020, before any constraints on such contributions take effect. In this scenario, donating more over the next couple of years would allow you to take advantage of a deduction that may disappear or be restricted in the future. If you’re unsure of which cause or organization to support, you could make a gift to a donor-advised fund (DAF) that would distribute grants to various organizations down the road.
- Accelerating or deferring ordinary income and capital gains this year, depending on whether you face higher or lower taxes under the proposals.

While it’s tempting to throw up your hands and delay taking action, that could be a mistake. Several strategies are likely to prove far more beneficial if adopted today instead of years from now, even if tax law doesn’t change or fluctuations prove transient. The key is to adopt a plan that limits your tax exposure and can be canceled at little or no cost, if the need arises.

INCOME-TAX RATE CHANGES: WHAT CAN YOU DO?
Portfolio tax-management represents a multiyear challenge that accounts for the impact of income taxes not just in the current year, but in future years. For instance, if you knew capital gains tax rates were set to rise, you might take gains in the current year. While this means remitting taxes today (and forgoing profit potential on the amount paid), avoiding the higher rate may be worth the opportunity cost of deferring that tax to a later date. Conversely, harvesting losses before an increase would be suboptimal because loss harvesting represents a deferral strategy. While it lowers the overall cost basis of your portfolio, it doesn’t eliminate the embedded gain—it simply defers it into a higher tax rate environment.

Here are some other choices your professional advisors can help you evaluate if and when it becomes clear how a change in the law will affect your tax liability:

- Relocating to a state with lower or no income taxes.
- Paying down your mortgage versus keeping funds invested in the capital markets. Depending on your interest rate and ability to deduct interest, the mortgage may cost more than you are earning from your portfolio.
- Accelerating charitable gifts in tax years 2019 and 2020, before any constraints on such contributions take effect. In this scenario, donating more over the next couple of years would allow you to take advantage of a deduction that may disappear or be restricted in the future. If you’re unsure of which cause or organization to support, you could make a gift to a donor-advised fund (DAF) that would distribute grants to various organizations down the road.
- Accelerating or deferring ordinary income and capital gains this year, depending on whether you face higher or lower taxes under the proposals.

While it’s tempting to throw up your hands and delay taking action, that could be a mistake. Several strategies are likely to prove far more beneficial if adopted today instead of years from now, even if tax law doesn’t change or fluctuations prove transient. The key is to adopt a plan that limits your tax exposure and can be canceled at little or no cost, if the need arises.

INCOME-TAX RATE CHANGES: WHAT CAN YOU DO?
Portfolio tax-management represents a multiyear challenge that accounts for the impact of income taxes not just in the current year, but in future years. For instance, if you knew capital gains tax rates were set to rise, you might take gains in the current year. While this means remitting taxes today (and forgoing profit potential on the amount paid), avoiding the higher rate may be worth the opportunity cost of deferring that tax to a later date. Conversely, harvesting losses before an increase would be suboptimal because loss harvesting represents a deferral strategy. While it lowers the overall cost basis of your portfolio, it doesn’t eliminate the embedded gain—it simply defers it into a higher tax rate environment.

Here are some other choices your professional advisors can help you evaluate if and when it becomes clear how a change in the law will affect your tax liability:

- Relocating to a state with lower or no income taxes.
- Paying down your mortgage versus keeping funds invested in the capital markets. Depending on your interest rate and ability to deduct interest, the mortgage may cost more than you are earning from your portfolio.
- Accelerating charitable gifts in tax years 2019 and 2020, before any constraints on such contributions take effect. In this scenario, donating more over the next couple of years would allow you to take advantage of a deduction that may disappear or be restricted in the future. If you’re unsure of which cause or organization to support, you could make a gift to a donor-advised fund (DAF) that would distribute grants to various organizations down the road.
- Accelerating or deferring ordinary income and capital gains this year, depending on whether you face higher or lower taxes under the proposals.

While it’s tempting to delay taking action, that could be a mistake. Several strategies are likely to prove far more beneficial if adopted today instead of years from now, even if tax law doesn’t change or fluctuations prove transient. The key is to adopt a plan that limits your tax exposure and can be canceled at little or no cost, if the need arises.
WHAT ABOUT DEFERRAL?
For net savers, tax-deferred savings accounts reduce current tax liability and allow assets to grow tax-free, potentially for decades. The catch? Funds are subject to ordinary income tax rates when withdrawn from the account. That leaves some investors wondering, “Should I continue to defer income into a potentially higher tax environment?” Let’s explore with an illustrative example.

Assume that a 40-year-old investor is contemplating annual, pretax contributions into her retirement portfolio. For our analysis, we compare two different levels for the top income tax rate under two different circumstances: saving in the present and withdrawing in the future. In all scenarios, we assume the investor will save for the next 25 years, starting at age 40, and compare total wealth at age 90 (net of all taxes).

Our base case attempts to mirror the current lower tax environment—a 50% top rate on income, which includes a high state income tax. To isolate the effects of a changing environment, we consider four distinct variations:

- A consistently low rate, 50% on ordinary income, in saving and retirement years (Consistently Low)
- A switch from low to high rates in retirement (Increasing)
- A switch from high to low rates in retirement (Decreasing)
- A consistently high rate, 70% on ordinary income, in saving and retirement years (Consistently High)

In all cases, we assume a 30% federal plus state rate on capital gains.

The top of Display 2 shows, not surprisingly, that the current low tax rate environment provides the greatest overall opportunity for wealth creation in tax-deferred accounts. Over a 50-year period, our investor has amassed 76% more wealth than saving through a taxable account. But our findings also show that even in the most extreme environment for tax deferral (the “Increasing” rate scenario), the advantage of tax-deferred portfolio growth outpaces simply saving in a taxable account for five decades. Under our “Increasing” scenario, our investor would end up with 8% more wealth than if she saved in a taxable account.

These observations offer an important insight. While higher future tax rates reduce the after-tax spending power of both taxable and tax-deferred assets, changes in rates over time impact the value of tax deferral most. This should not discourage investors, though. Even in these extreme scenarios, they come out ahead when deferring taxes over extended time horizons. However, there is one caveat. In a rising tax rate environment, you need to have a long enough time horizon between the deferral and the withdrawal in order to take full advantage. To illustrate, we recalculated the example above with a 55-year-old retiring at age 65 and living until age 90.

In our revised circumstances (Display 2, bottom), the spendable dollar in the Increasing rates scenario was nearly even. In other words, there was no benefit given the relatively short, 10-year deferral period. If the investor faced an even shorter horizon, deferral alone may not make sense. However, a combined strategy like deferral plus a partial Roth conversion might improve the outcome. Plus, a...
number of other factors merit consideration, including the degree
to which federal rates actually increase and whether an investor’s
state income tax rate will change in retirement. The bottom line? It’s
critical to sharpen your pencil and look at all angles before executing
a plan.

TRANSFER TAX ISSUES

On the wealth transfer front, there’s far more to do immediately—
particularly for very wealthy families—and some potential
consequences that a broader group of Americans with substantial
means should consider.

TRANSFER TAX SUNSET: THESE DEALS WON’T LAST

Although the current basic exclusion amount will not “sunset”
until after 2025, many practitioners see the 2020 election as a
motivating force in clients’ plans. The IRS clarified in late 2018 that
if a taxpayer uses today’s higher exclusion amount during the period
that it is available, it will not result in a future “clawback” tax, as some
practitioners had feared.

3 Some states impose an additional "death tax" and one state, Connecticut, imposes a tax on certain lifetime gifts.

TODAY’S TRANSFER TAX LANDSCAPE

The TCJA brought some favorable but temporary changes to
the gift, estate, and generation-skipping transfer (GST) taxes.
The headline? The federal basic exclusion amount for gift and
estate taxes increased from $5 million to $10 million per person
for an individual, and twice that amount for a couple. It will also
be indexed for inflation.

With the inflation adjustment, the per-person exclusion sits at
$11.4 million in 2019, and $22.8 million per couple. After various
exemptions, deductions, and credits, all three transfer taxes
now have a top rate of 40%. However, we expect this exclusion
to sunset after 2025 and revert to half its current level, which
(after adjusting for inflation) is likely to be roughly $6.7 million.

What’s the difference between these transfer taxes? The
gift and estate tax applies to transfers during life and at
death, respectively, that don’t qualify for one of the various
exemptions or deductions and that exceed your basic exclusion.
Current law allows individuals to give away $15,000 a year
during their lifetime (married couples, $30,000), adjusted for
inflation, to as many individuals as they want, without incurring
gift tax or using any of their basic exclusion. Over time, the
annual exclusion of such gifts to children and grandchildren can
shield meaningful wealth from taxation.

The GST tax applies to gifts during life and transfers at death
to grandchildren, later generations, and unrelated individuals
more than 37½ years younger than the giver, known as “skip
persons.” The GST tax is levied on top of gift and estate
taxes. Like the exclusion for the gift and estate taxes, the GST
tax exemption currently stands at $11.4 million (indexed to
inflation) per individual until 2025 when this too will “sunset”
back to half its current level, adjusted for inflation.

True, the path of interest rates remains uncertain and rates have
trended down early in 2019, reflecting expectations for slower
growth and lower inflation. But macro trends can change quickly.
For example, rising wages and/or politically driven increases in
fiscal stimulus could stoke inflation and cause interest rates to drift
upward from today’s low levels more rapidly than anticipated. That
matters, because many planning strategies perform most effectively
in low-interest-rate environments—like today.
So how should families proceed? There are several different ways to transfer wealth tax-efficiently. Typically, families transfer assets temporarily to an irrevocable trust or another estate-planning vehicle, while retaining the right to receive back the value of those assets in the future, with interest charged at today's low rates.

Yet while a substantial gift may seem straightforward, many families hesitate to pull the trigger. For them, a transfer of future growth—rather than a gift of “principal”—may make sense. If the assets grow faster than prevailing interest rates, the trust keeps and reinvests the excess. Typically, the donor retains the obligation to pay income taxes on behalf of the trust and its beneficiaries, rather than passing that burden on to the recipients; such a trust is called a “grantor” trust.

Over time, these growth-transfer strategies can shift a mountain of wealth for the benefit of younger generations, with little or no gift tax, no estate tax—and if properly structured—without being subject to GST tax. The family’s senior generation need not give away current wealth to realize tremendous estate-tax savings. Instead, they give away only the future growth of existing assets while picking up the tab, for income taxes, on that growth.

The following case study—“The Foxes Choose a SLAT”—is based on real clients and shows how a combination of growth-transfer strategies and a grantor trust can work well in today’s environment.

**CASE STUDY: THE FOXES CHOOSE A SLAT**

50-year-old entrepreneurs Steve and Edie Fox benefit from a substantial portfolio stemming from the recent sale of a company they built, along with continuing interests in several other businesses. The Foxes would like to take advantage of the current exclusion before it sunsets, but consider their three children—ages 15, 17, and 20—much too young to handle considerable wealth.

Under such a plan, if the tax laws “zig,” repealing transfer taxes or moving to another tax system, the family can shift to a more aggressive wealth transfer strategy that takes advantage of favorable changes in the law. If the tax laws “zag,” leaving current transfer tax law unchanged or making them less favorable, the family will already have locked in today’s low interest rates in a way that’s likely to produce substantial benefits over time.

The following case study—“The Foxes Choose a SLAT”—is based on real clients and shows how a combination of growth-transfer strategies and a grantor trust can work well in today’s environment.

The couple has a basic testamentary estate plan that calls for establishing a credit shelter trust when either Steve or Edie dies for the benefit of the surviving spouse and children. Small gifts to beneficiaries...
children and charity aside, the Foxes have not previously considered transferring wealth during their lifetimes.

If the first death occurred today, the credit shelter trust would receive $11.4 million—the full exclusion allowable under current law—which would remove those assets and any future growth from the estate of the surviving spouse. The survivor would inherit the remainder of the estate in a “marital deduction trust” for his or her benefit. Estate tax on that trust would be postponed until the surviving spouse’s death; therefore, no estate tax would be paid at the first death.

Our analysis of the Fox family’s finances determined that they can easily afford to give away a portion of their portfolio, along with some of their portfolio’s future growth, during their lifetime. With the approval of their estate-planning attorney, we proposed that Steve create a certain kind of irrevocable grantor trust, known as a “spousal lifetime access trust,” or SLAT. Edie will be a co-trustee and the primary beneficiary of the trust; the children will be contingent beneficiaries (Display 3).

Because Edie, rather than the children, will be the primary beneficiary of the trust during her lifetime, the SLAT essentially represents a lifetime version of the credit shelter trust. In effect, the new plan accelerates the creation and funding of the credit shelter trust that would be established at Steve’s death under their current plan. The main difference? Because this is a grantor trust, Steve will be responsible for paying all trust income taxes (at least for now).

THE BENEFITS
One of the primary benefits of a SLAT is allowing the couple to transfer the future growth of assets without losing access to that growth. If properly drafted, assets held in the new SLAT will avoid estate tax at Steve’s or Edie’s death, without losing protection from the claims of either Steve’s, Edie’s, or the children’s future creditors. If Edie remarries after Steve’s death, the trust could be drafted in a way that sequesters trust assets from her new spouse.

Under the laws of most states, a SLAT can be drafted so that the children receive little or no information about its existence until they become primary beneficiaries under rules specified in the trust instrument—which could be well after they reach adulthood. On the other hand, the trust remains flexible enough to provide Edie with a way to make the children (or others) the primary beneficiaries. Under a mechanism called a “special (or limited) power of appointment,” Edie can, in effect, “promote” the children to primary status—if and when she decides they appear ready to assume the responsibilities of substantial wealth.

Potential benefit to trust and its beneficiaries equals post-transfer growth of assets given, plus growth of assets sold in excess of interest payable. For illustrative purposes only; this is not an advertisement and does not constitute an endorsement of any particular wealth transfer strategy. Source: Bernstein

---

**DISPLAY 3: HOW AN INSTALLMENT SALE TO A GRANTOR SLAT WORKS**

<table>
<thead>
<tr>
<th>SLAT Grantor Spouse</th>
<th>Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Note Payments</td>
<td></td>
</tr>
<tr>
<td>Discretionary Distributions</td>
<td></td>
</tr>
<tr>
<td>Beneficiary Spouse (and others, if desired)</td>
<td></td>
</tr>
<tr>
<td>Income Taxes</td>
<td>Government</td>
</tr>
</tbody>
</table>

Potential benefit to trust and its beneficiaries equals post-transfer growth of assets given, plus growth of assets sold in excess of interest payable. For illustrative purposes only; this is not an advertisement and does not constitute an endorsement of any particular wealth transfer strategy. Source: Bernstein
What’s more, nothing dictates that the children receive distributions from the trust at any given age—or for that matter, any trust distributions at all—should the trustee determine that they don’t need the money. And as long as the beneficiary spouse remains alive, the trustee can distribute trust property to that spouse, bringing those funds back onto the marital balance sheet, if necessary.

LIMITATIONS AND RISKS

At this point, you may be wondering, “Can Edie simultaneously create a SLAT for Steve?” Yes, provided the trust for Steve’s benefit is not substantially identical to the trust for Edie’s benefit. In estate-planning lingo, the two trusts cannot be “reciprocal.” Preparing SLATs, and especially more than one SLAT, can be complex. Please consult with your estate planning attorney for legal advice.

If either partner were even remotely concerned about the possibility of divorce, their attorney could build safeguards into the trust document to ensure that the children and future generations would ultimately receive the lion’s share of the benefits. We should also note that death of the beneficiary spouse also poses a risk, though it can be mitigated with life insurance or other mortality-hedging strategies.

EVALUATING THE LIKELY OUTCOMES

There are various ways to fund a SLAT, including direct gifts. Among the principal alternatives we examined: making a gift, executing an installment sale, or using a series of short-term rolling grantor retained annuity trusts (GRATs).

The gift represents the least complicated option. Steve would tap some, or perhaps even all, of his $11.4 million exclusion to fund the trust. Yet opting for simplicity means losing some flexibility—and potentially forgoing a “free” step-up in cost basis. To create an “apples to apples” comparison on using exclusion, we have shown what happens if a gift was added on to a GRAT or installment sale strategy at the end of the sixth year.

From a purely financial standpoint, the strategies are nearly equal. Display 4 illustrates the range of assets we would expect to remain in the SLAT six years after funding each of three different strategies with $1 million.
But rolling GRATs work best when funded with marketable stocks, not other assets like business interests. And more to the point, given current tax law uncertainty, a GRAT would be more difficult to unwind. In contrast, an installment sale to a SLAT or another irrevocable grantor trust can be easily terminated. If the Foxes used an installment sale strategy to move assets to a SLAT on Monday, and changed their minds by Tuesday, the trustee could repay the note (plus one day’s interest) and collapse the transaction; the couple would be right back where they started, minus attorney’s fees.

What if Steve sold assets to the SLAT, and a few months later the federal estate and gift taxes were repealed? He could forgive the promissory note, complete the gift, and take advantage of the (perhaps temporary) elimination of the gift tax to move the assets off the couple’s balance sheet. And if tax law remains essentially unchanged for many years? No problem. The Foxes can keep the sale-and-loan structure in place for the entire nine years, taking full advantage of today’s low-interest-rate environment. Given the couple’s assets and prevailing uncertainty surrounding the tax environment, the Foxes and their estate tax attorney opted to use an installment sale to transfer assets to a SLAT.

Whether you’re planning for income or estate taxes, some form of change is likely looming on the horizon over the next several years. At Bernstein, we’re committed to keeping pace with the coming changes and helping to explain how the evolving tax landscape may impact your long-range goals.
Notes on the Bernstein Wealth Forecasting System℠

The Bernstein Wealth Forecasting System℠ seeks to help investors make prudent decisions by estimating the long-term results of potential strategies. It uses the Bernstein Capital Markets Engine to simulate 10,000 plausible paths of return for various combinations of portfolios. For taxable accounts, it takes the investor's tax rate into consideration. Additional information on Bernstein's Wealth Forecasting System is available upon request.

Note to All Readers
Logos, brands, and other trademarks in this presentation are the property of their respective trademark holders. They are used for illustrative purposes only, and are not intended to convey any endorsement or sponsorship by, or association or affiliation with, the trademark holders.

The information contained herein reflects the views of AllianceBernstein L.P. or its affiliates and sources it believes are reliable as of the date of this publication. AllianceBernstein L.P. makes no representations or warranties concerning the accuracy of any data. There is no guarantee that any projection, forecast, or opinion in this material will be realized. Past performance does not guarantee future results. The views expressed herein may change at any time after the date of this publication. This document is for informational purposes only and does not constitute investment advice. References to specific securities discussed are not to be considered recommendations by AllianceBernstein L.P. It does not take an investor’s personal investment objectives or financial situation into account; investors should discuss their individual circumstances with appropriate professionals before making any decisions. AllianceBernstein L.P. does not provide tax, legal, or accounting advice. This information should not be construed as sales or marketing material or an offer or solicitation for the purchase or sale of any financial instrument, product, or service sponsored by AllianceBernstein or its affiliates.